TITLE 18. FRANCHISE TAX BOARD
AMENDMENTS TO PROPOSED
REGULATION SECTION 25136, RELATING TO
SALES OF OTHER THAN TANGIBLE PERSONAL PROPERTY

A hearing was held on August 10, 2011, by Melissa Potter of the Franchise Tax Board Legal Division, the "hearing officer," on proposed amendments to California Code of Regulations, title 18, section 25136 (Regulation section 25136), which was noticed in the California Regulatory Notice Register on June 17, 2011.

Department staff reviewed the proposed regulation language and considered the comments submitted at and before the hearing. The hearing officer recommends that the proposed new regulation section number be renumbered for clarity to 25136-2. The hearing officer also recommends that (1) a definition be deleted as unnecessary and another definition be expanded to include limitations that appear in various subsections; (2) examples be added or changed to indicate how all cascading rules operate; (3) examples that follow the cascading rules be identified by the subsection to which they apply; (4) language be added or altered to clarify the provision or to maintain consistency in phraseology throughout this regulation and/or other California regulations; and (5) a provision be added to address how to assign the receipt where there has been a sale of an interest in a corporation or pass-through entity.

These nonsubstantial or sufficiently related changes (within the meaning of Govt. Code Section 11346.8) recommended by the hearing officer are reflected in the attachment hereto. These amendments to the regulation are reflected by underscore for additions and strikeout for deletions. Proposed changes to Regulation section 25136 are summarized below.

1. In a number of places, either a provision has been deleted in its entirety or new one has been inserted. For example, the definition of commercial domicile has been deleted (formally subsection (b)(4)). As a result, the numbering and/or lettering of the regulation subsections have changed in some cases. This is indicated by strikeout or underscore of the number or letter being removed and/or being added. The subsections referred to in these paragraphs refer to the newly assigned number or letter as assigned by this 15 day notice's proposed changes.

2. Many examples have been modified to identify the subsection to which they specifically relate, for instance "Benefit of a Service – Individuals, subsection (c)(1)(A)." This has been done for clarity purposes, in particular where there are examples that appear back-to-back to illustrate an entire set of cascading rules for a particular subsection. This addition is indicated by underscore of the term that identifies the subsection to which the example applies.

3. The regulation section number has been revised to read "25136-2." The regulation number itself was originally titled "25136(b)" to follow the numbering of the underlying statute for market-based rules of assignment of sales. However, in previous regulations, the Franchise Tax Board has used a dash-number system, i.e., California Code of Regulations, title 18, section 25137-1 et seq. This numbering system was adopted to avoid confusion with subsection "(a)" in the number of the regulation itself with a subsection "(a)" immediately following in the body of the regulation. As a result, this proposed new

regulation section number has been renumbered to "25136-2", with the "(b)" deleted. The cost of performance provisions in existing Regulation section 25136 will be renumbered to 25136-1 with a subsequent Form 100 change.

> §25136~~(b)~~ 2. Sales Factor. Sales Other than Sales of Tangible Personal Property in this State.

4. Subsection (a), In General, has been revised to add Revenue and Taxation Code section 25135 (sales of tangible personal property), and change the reference to Revenue and Taxation Code section "25136" to "25136(a)." Originally, this subsection was intended to define sales as other than those sales of tangible personal property under Revenue and Taxation Code section 25135 and sales determined under income-producing activity/cost of performance rules under Revenue and Taxation Code section 25136, subdivision (a). Instead, when drafted, Revenue and Taxation Code section 25135 was omitted entirely, and the income-producing activity/cost of performance rules were mistakenly referenced as Revenue and Taxation Code section "25136" and not "25136(a)." To clarify that assignment of both type sales are not governed by this regulation's market-based rules, a reference to Revenue and Taxation Code section 25135 for sales of tangible personal property was added and Revenue and Taxation Code section 25136 was identified correctly as "25136, subdivision (a)," to reference assignment of sales under the income producing activity/cost of performance rules.

> In General. Sales other than those described under Revenue and Taxation Code Sections ~~25136~~ 25135 and 25136, subdivision (a), are in this state if the taxpayer's market for the sales is in this state.

5. Subsection (b)(4), which provided the definition of "commercial domicile," has been deleted. In an earlier draft, commercial domicile appeared as one of the cascading rules. The only place where "commercial domicile" appears in the current draft is in some of the examples for the definition of "benefit of a service is received." The definition of commercial domicile has been deleted because it is no longer necessary and in order to avoid confusion as to whether it is one of the cascading rules.

> ~~(4) "Commercial domicile" means the principal place from which the trade or business of the taxpayer is directed or managed.~~

6. Subsection (b) contains the definitions for the regulation's provisions. The terms being defined have been reorganized alphabetically such that "Benefit of the service is received" is (b)(1) and is followed by "Cannot be determined" as (b)(2), which is in turn followed by "Intangible property" at (b)(3), "Reasonably approximated" at (b)(4), "Service" at (b)(5), "The use of intangible property in this state" at (b)(6) and "to the extent" at (b)(7).

7. Subsection (b)(3)(B), which defines "non-marketing and manufacturing intangible," has been revised to include the language "or other non-marketing process" and insert the word "property" after the word "intangible." These changes were made so that the terms are accurately and consistently phrased throughout the regulation. Both terms should have been originally included in the definitional section "non-marketing and manufacturing intangible" but the language was inadvertently omitted.

(B) A "non-marketing and manufacturing intangible" includes, but is not limited to, the license of a patent, a copyright, or trade secret to be used in a manufacturing or other non-marketing process, where the value of the intangible property lies predominately in its use in such process.

8. Subsection (b)(3)(C), which defines "mixed intangible," was revised to list specific types of intangible property, i.e. "a patent, copyright, service mark, trademark, trade name, or trade secrets", and delete the general term "intangible property that includes both a license of a marketing intangible and a license of a non-marketing intangible." Listing specific types of intangible property is a preferable way to define intangible property rather than using general terms to define it. Also, the phrase "includes but is not limited to" has been inserted to make it clear that the list is non-exclusive. Lastly, an unnecessary space between the word "intangible" and a quote mark was removed.

(C) A "mixed intangible-" includes, but is not limited to, the license of a patent, copyright, service mark, trademark, trade name, or trade secrets ~~intangible property that includes both a license of a marketing intangible and a license of a non-marketing intangible~~ where the value lies both in the marketing of goods, services or other items as described in subparagraph (A) and in the manufacturing process or other non-marketing purpose as described in subparagraph (B).

9. Subsection (b)(4), which defines "reasonably approximated," a cascading rule for assignment of sales that appears in various subsections throughout this regulation, has been revised in several ways. In general, the definition has been broadened to indicate that reasonable approximation is limited to the jurisdiction or geographic area where the customer receives the benefit of the service or uses the intangible property. Also, if reasonable approximation is by population, it must be determined by U.S. population unless it can be shown by the taxpayer that the benefit is received or the intangible property is used materially in other parts of the world. These limitations originally appeared only in the reasonable approximation provisions for sales of intangible property but not in the definition or in the reasonable approximation provisions for sales of services. A commenter on this regulation suggested that at least the population language of the reasonable approximation provisions for sales of intangible property should be brought into the definitional language of reasonable approximation. Ultimately, it was felt that all limitations (not just the population limitations) that appeared in the reasonable approximation provisions for sales of intangible property should appear in the definition of reasonable approximation and apply to the entire regulation. As a result, all limitations now appear in the definition of "reasonable approximation" and have been deleted from the reasonable approximation provisions for sales of intangible property as redundant. The limitations apply when reasonably approximating both sales of services and sales of intangible property. Specific changes to the definition include the following.

First, the word "business" is exchanged for the word "activities." Originally, the term "reasonably approximated" was stated throughout the regulation with the proviso "that is consistent with the *activities* of the customer..." [emphasis added.] However, the definition originally read "that is consistent with the *business* of the customer..." [emphasis added.] Since some customers may not be business entities or a customer's business may be

irrelevant to the services rendered, it would be more appropriate to refer to the customer's "activities" in getting to the taxpayer's market.

Second, in other subsections of the regulation, reasonable approximation is to be determined "in a manner that is consistent with the activities of the customer" but limited by the proviso "to the extent such information is available to the taxpayer." This provision was intended to provide fairness to the taxpayer who may or may not have access to such information regarding its customer. However, while that language appeared throughout this regulation's provisions regarding reasonable approximation, that language did not appear in the definition. It has been inserted into the definition and removed from individual provisions as now redundant.

Third, geographic and/or jurisdictional limitations have been inserted for reasonably approximating where the benefit of the service has been received and the location of the use of the intangible property. The benefit of the service must be "substantially" received and the intangible property "materially" used in other parts of the world if those parts of the world are to be included in the population data for reasonable approximation. The purpose of such limitations is to ensure that only the actual market for the services or intangible property is considered in the reasonable approximation.

Fourth, population has been defined to be determined "by U.S. census data." This addition provides a method of determining population numbers. This change was made pursuant to a comment received for this regulation.

(4) "Reasonably approximated" means that, considering all sources of information other than the terms of the contract and the taxpayer's books and records kept in the normal course of business, the location of the market for the benefit of the services or the location of the use of the intangible property is determined in a manner that is consistent with the ~~business~~ activities of the customer to the extent such information is available to the taxpayer. Reasonable approximation shall be limited to the jurisdictions or geographic area where the customer or purchaser, at the time of purchase, will receive the benefit of the services or use the intangible property, to the extent such information is available to the taxpayer. If population is a reasonable approximation, the population used shall be the U.S. population as determined by the most recent U.S. census data. If it can be shown by the taxpayer that the benefit of the service is being substantially received or intangible property is being materially used in other parts of the world, then the populations of those other countries where the benefit of the service is being substantially received or the intangible property is being materially used shall be added to the U.S. population. Information that is specific in nature is preferred over information that is general in nature.

10. Subsection (b)(6), which originally defined the term "Intangible personal property is used," has been revised so that the term being defined is worded exactly as it appears throughout the language in subsection (d). As a result, "intangible personal property is used" has replaced with "the use of intangible property in this state". In addition, the definition has been expanded to address new provisions, subsections (d)(1)(A)1 and (d)(1)(A)1.a and b, which have been added to the sale of intangible property in the case where the stock of a

corporation or an interest in a pass-through entity has been sold. Thus, language has been added to the definition to state that the location of the use of the intangible property is the location of the use of the underlying assets of the business entity sold.

(6) ~~"Intangible personal property is used"~~ "[T]he use of intangible property in this state" means the location where the intangible property is employed by the taxpayer's customer or licensee. In the case of the complete transfer of all property rights in stock of a corporation or interest in a pass-through entity, the location of the use of the stock of the corporation or interest in the pass-through entity is the location of the use of the underlying assets of the corporation or pass-through entity.

11. Subsections (c)(1) and (c)(1)(A) previously provided the first cascading rule for the assignment of sale of services to individuals. Now, (c)(1) has been revised so that it is a segue to the cascading rules for assignment of sales of services to individuals, which now appear below it in subsections (c)(1)(A) and (B). This format is cleaner and clearer: all cascading rule subsections are contained within the same subsection format, i.e. (c)(1)(A) and (c)(1)(B), and not as they were previously set forth, subsections (c)(1) and (c)(1)(A). Also, this format is consistent with those provisions for cascading rules in subsection (d) for sales of intangible property. The following specific changes have been made.

First, "receipt of" has been inserted in front of the words "the benefit of the service" to be consistent with the statutory language as well as other provisions of this regulation. Second, "determined as follows:" has been added to indicate this subsection as the segue for the cascading rules to come under subsections (c)(1)(A) and (B). Third, the language of the first cascading rule has been deleted.

(1) In the case where an individual is the taxpayer's customer, receipt of the benefit of the service shall be ~~presumed to be received at the billing address of the taxpayer's customer, as determined at the end of the taxable year. If the taxpayer uses the customer's billing address as the method of assigning the sales to this state, the Franchise Tax Board will accept this assignment~~ determined as follows:

12. Subsection (c)(1)(A) now contains the first cascading rule of assignment to the customer's billing address, previously set forth in subsection (c)(1). To be consistent with other subsections of this regulation, the subsection starts with "The location of the benefit of the service..." Then, the cascading rule is inserted immediately preceding the original language of subsection (c)(1)(A), which provided the method for overcoming the presumption that the billing address is the location where the benefit of the services is received.

Other modifications have been made to make the language consistent with other provisions of this regulation as well as other regulations. First, the phrase "in this state" was added to the first sentence of subsection (c)(1)(A) for clarification that the sale would be assigned to this state if the billing address were in this state. This was done to be consistent with the language of other subsections in this regulation as well as other Revenue and Taxation Code and Regulation sections. Typically, under Revenue and Taxation Code and Regulation sections, in connection with assignment of an item to a state under any of the apportionment factors, assignment will be made "in this state" as opposed to "California" or

any location in general. Second, "by" was replaced with "based on" for consistency with other similar provisions in this regulation. Third, "benefit of the" was added before the word "service" to be consistent with the statutory language. Fourth, "[P]erformed" was replaced by "received" also to be consistent with the statutory language and its market-based intent as well as to make this provision consistent with similar provisions in this regulation. This last change was made pursuant to a comment made at the hearing on this regulation.

(A) The location of the benefit of the service shall be presumed to be received in this state if the billing address of the taxpayer's customer, as determined at the end of the taxable year, is in this state. If the taxpayer uses the customer's billing address as the method of assigning the sales to this state, the Franchise Tax Board will accept this assignment. This presumption may be overcome by the taxpayer by showing, ~~by~~ based on a preponderance of the evidence, that either the contract between the taxpayer and the taxpayer's customer, or other books and records of the taxpayer kept in the normal course of business, provide the extent to which the benefit of the service is ~~performed~~ received at a location (or locations) in this state. If the taxpayer believes it has overcome the presumption and uses an alternative method based on either the contract between the taxpayer and the taxpayer's customer or other books and records of the taxpayer kept in the normal course of business, the Franchise Tax Board may examine the taxpayer's alternative method to determine if the billing address presumption has been overcome and, if so, whether the taxpayer's alternate method of assignment reasonably reflects where the benefit of the service was received by the taxpayer's customers.

13. Subsection (c)(1)(B) is the second cascading rule for the assignment of sales of services made to individuals. The first point of this second cascading rule is that the presumption in the first cascading rule, that the billing address is presumed to be the location where the benefit of the services are received, must be overcome prior to application of the second cascading rule, and, in addition, that there are no alternate methods that can be determined by looking at the contract with the customer or the taxpayer's books and records. To make the subsection clearer and consistent with the wording of other similar provisions in this regulation, "yet no" has been deleted and replaced with "and an" so that the sentence reads that if the presumption in the first cascading rule is overcome "and an alternate method cannot be determined..." then assignment shall be reasonably approximated. "Determined" is the preferred term in this context and is consistently used throughout this regulation and so replaces "derived." Finally, throughout this regulation when referring to the "taxpayer's contract with its customer or the taxpayer's books and records", the "taxpayer's contract with its customer" is listed first and the "taxpayer's books and records" is listed second. This subsection is modified to reflect that consistent order.

(B) If the presumption in (c)(1)(A)is overcome by the taxpayer, ~~yet no~~ and an alternative method cannot be ~~derived~~ determined by reference to the contract between the taxpayer and its customer or the taxpayer's books and records ~~of the taxpayer~~ kept in the normal course of business ~~or the contract between the taxpayer and its customer,~~ then the location where the

benefit of the services is received by the customer shall be reasonably approximated.

14. Subsection (c)(1)(C)1 provides an example of the assignment of sales of services to individuals. It has been completely revised to illustrate possible different facts in the case of sales of services within the telecommunications industry which facts would indicate that for some telecommunication taxpayers the billing address would not reflect the market of its consumers, and the market for telecommunications services might be more accurately determined by the net plant method of assigning sales consistent with the Franchise Tax Board's Multistate Audit Technical Manual section 7805. This amendment was requested by a commenter on this regulation.

1. ~~Phone Corp provides telecommunications services to individuals in this state and other states for a monthly fee billed to the customer's address. Gross receipts from these services are assigned to this state if the billing address of the customer is in this state.~~

   Benefit of a Service – Individual, subsection (c)(1)(A). Phone Corp provides interstate communications and wireless services to individuals in this state and other states for a monthly fee. The vast majority of consumers of mobile services receive the benefit of the services at many locations. As a result, a customer's billing address may not be reflective of the location where the benefit of the services is received by the customer. Phone Corp has net plant facilities located in geographical areas where customers utilize its services, based on market size and demand. Phone Corp's books and records, kept in the normal course of the business, identify the net plant facilities used in providing the communications services to Phone Corp's customers. Because Phone Corp's books and records show where the benefit of the services is actually received, the presumption of billing address is overcome. Receipts from interstate communications and wireless services may be attributable to this state based upon the ratio of California net plant facilities over total net plant facilities used to provide those services. Revenues from interstate and international calls may be included in the numerator based upon California net plant facilities used in the call to total net plant facilities used in the call.

15. Subsection(c)(1)(C)2 is another example for assignment of sales of services to individuals. Originally, the second paragraph of this example had not been numbered or lettered. The second paragraph has now been pulled up into the first paragraph, subsection (c)(1)(C)2. This change was made for clarity and consistency with other examples within this regulation.

In addition, the example has been revised in several other ways. First, the phrase "books and" has been inserted in front of the word "records." This term with the inserted words is consistent with other similar provisions throughout this regulation and other Revenue and Taxation Code and Regulation provisions. Second, after the word "records" the phrase "maintained in the regular course of business" was inserted. The phrase "books and records"

usually appears with the modifying phrase "maintained in the regular course of business" when initially referred to in a subsection. This is consistent with other provisions throughout this regulation as well as other Revenue and Taxation Code and Regulation sections. However, when the term "books and records" is mentioned a second time in the same subsection, the modifying term "maintained in the regular course of business" need not appear, as it is generally understood that the books and records are the same books and records identified earlier in the subsection. As a result, the second reference to "maintained in the regular course of business" in this subsection was deleted.

2. Benefit of the Service – Individual, subsection (c)(1)(A). Travel Support Corp located in this state provides travel information services to its customers, who are individuals located throughout the United States, through a call center located in this state. The contract between Travel Support Corp and its customers provides that for a fee per call, the customer can call Travel Support Corp for information regarding hotels, restaurants and other travel related information. Travel Support Corp's books and records maintained in the regular course of business indicate that fifteen (15) percent of its customers have billing addresses in this state. However, Travel Support Corp's books and records~~, maintained in the regular course of business,~~ indicate that only seven (7) percent of the calls handled by the call center originate from this state. Because Travel Support Corp's books and records show where the benefit of the services is actually received, the billing address presumption is overcome and the books and records of the taxpayer may be used to assign seven (7) percent of the gross receipts from the support services provided by the call center to this state.

16. Subsection (c)(1)(C)3 is an example of when a taxpayer may not overcome the presumption that the billing address is the location where the benefit was received. This example was revised to give a reason as to why the presumption was not overcome. After the language "The fact that only seven (7) percent of the calls originate from this state does not overcome the presumption that the benefit of the services is received at the billing address", the statement "This is because the charges are not based on a per call basis but rather a flat monthly fee" was added.

3. Benefit of the Service – Individual, subsection (c)(1)(A). Same facts as Example 2 except the contract between Travel Support Corp and its customers provides for a set monthly fee, regardless of whether the customer actually calls for travel support. This is because the charges are not based on a per call basis but rather a flat monthly fee.

17. Subsection (c)(1)(C)4 was inserted to provide an example as to how the cascading rule of reasonable approximation for sales of services to an individual works. It has been identified as "Benefit of the Service – Individual, subsection (c)(1)(B)." An example of this cascading rule had not been provided in previous drafts. It is the intent of the Department to provide at least one example for every cascading rule to show how each rule works.

4. Benefit of the Service – Individual, subsection (c)(1)(B). Satellite Music Corp has a contract with Car Dealer Corp to provide satellite music service to Car Dealer Corp's retail customers who buy Make and

Model X car. Car Dealer Corp's customers pre-pay for a two (2) year service plan to receive satellite music at a discounted rate as part of the purchase price of the Make and Model X car. While Satellite Music Corp requires an email address for Car Dealer Corp's customers who receive the benefit of this service, Satellite Music Corp does not have access to information as to the billing address or physical location of Car Dealer Corp's customers. Satellite Music Corp may reasonably approximate the location where Car Dealer Corp's customers receive the benefit of its satellite music service by a ratio of the number of Car Dealer Corp locations that offer the two (2) year service plan with Satellite Music Corp to its customers in this state to the number of Car Dealer Corp locations that offer the two (2) year service plan with Satellite Music Corp to its customers located everywhere.

18. Subsections (c)(2) and (c)(2)(A) originally provided the first cascading rule for sales of services to business entities. Now (c)(2) has been revised so that it is a segue to the cascading rules for assignment of sales of services to business entities that appear below it in (A) through (D). This type of format is cleaner and clearer: all cascading rule subsections are contained within the same subsection, i.e. (A) through (D) and not as they were previously set forth in subsection (c)(2), i.e. (2) and (2) (A) through (C). Also, this format is consistent with the provisions for cascading rules in (d), sales of intangible property.

In subsection (c)(2), several changes have been made. First, "receipt of" has been inserted in front of the words "the benefit of the service" to be consistent with the statutory language as well as other provisions of this regulation. Second, "determined as follows:" has been added to indicate this subsection is the segue for the cascading rules to come under subsections (A) through (D) in connection with assignment of sales of services to business entities. Third, the language of the first cascading rule that assignment will be determined by the contract with the customer or the taxpayer's books and records has been deleted.

(2) In the case where a corporation or other business entity is the taxpayer's customer, receipt of the benefit of the service shall be ~~presumed to be received at the location (or locations) indicated by the contract between the taxpayer and the taxpayer's customer or the taxpayer's books and records, notwithstanding the billing address of the taxpayer's customer~~ determined as follows:

19. Subsection (c)(2)(A) now contains the first cascading rule of assignment based on the contracts with the customer or the taxpayer's books and records previously set forth in (c)(2). In addition, this rule was modified so that the language is consistent with other provisions in this regulation and other regulations. Hence, the provision starts with "The location of the benefit of the service..." Then, the cascading rule is inserted immediately preceding the original language of subsection (c)(2)(A) on how a taxpayer may overcome the presumption that the contract or the taxpayer's books and records indicates the location where the benefit of the services is received. Lastly, "upon an evidentiary showing" was deleted and inserted after "by" is "showing based on" also to be consistent with other similar provisions of the regulation. Commas were added where appropriate in that same sentence.

(A) ~~To the extent that the contract between the taxpayer and the taxpayer's customer or the taxpayer's books and records (notwithstanding the billing address of the taxpayer's customer) kept in the normal course of business provide the location (or locations) where the benefit of the services is received, such location (or locations) will be presumed to be where the benefit of the service is actually received.~~ The location of the benefit of the service shall be presumed to be received in this state to the extent the contract between the taxpayer and the taxpayer's customer or the taxpayer's books and records kept in the normal course of business, notwithstanding the billing address of the taxpayer's customer, indicate the benefit of the service is in this state. This presumption may be overcome by the taxpayer or the Franchise Tax Board ~~upon an evidentiary showing~~ by showing, based on a preponderance of the evidence, that the location (or locations) indicated by the contract or the taxpayer's books and records was not the actual location where the benefit of the service was received.

20. Subsection (c)(2)(C), the third cascading rule for assignment of sales of services to business entities, has been revised to insert the phrases "in this state if" and "is in the state" to be consistent with the language of other subsections in this regulation as well as other Revenue and Taxation Code and Regulation sections. Typically, under the Revenue and Taxation Code and other Regulations, in connection with assignment of an item to a state under any of the apportionment factors, assignment will be made "in this state" as opposed to "California" or any location in general. Insertion of the phrase, "is in this state", at the end of the sentence completes the sentence.

(C) If the location where the benefit of the service is received cannot be determined under subparagraph (A) or reasonably approximated under subparagraph (B), then the location where the benefit of the service is received shall be presumed to be in this state if the location from which the taxpayer's customer placed the order for the service is in this state.

21. Subsection (c)(2)(E)3 provides an example for the first cascading rule for sales of services to business entities and provides guidance on how either the contract between the taxpayer and its customer or a taxpayer's books and records can determine the location where the benefit of the services was received by a business entity customer. The word "its" was exchanged for the term "Client Corp's" so that the facts are clearer.

3. Benefit of the Service – Business Entity, subsection (c)(2)(A). Audit Corp is located in this state and provides accounting, attest, consulting, and tax services for Client Corp. The contract between Audit Corp and Client Corp provides that Audit Corp is to audit Client Corp for taxable year ended 20XX. Client Corp's books and records kept in the normal course of business, as well as ~~its~~ Client Corp's internal controls and assets, are located in States A, B and this state. As a result, Audit Corp's staff will perform the audit activities in States A, B and this state. Audit Corp's business books and records track hours worked by location where its employees performed their service. Audit Corp's receipts are attributable to this state and States A and B

according to the taxpayer's books and records which indicate time spent in each state by each staff member.

22. Subsections (c)(2)(E)4 and 5 are examples based on similar facts exhibiting how the books and records cascading rule and the reasonable approximation cascading rule works for sale of services to business entities. Originally, the first paragraph under (c)(2)(E)4 was numbered 4.a and the second paragraph was numbered 4.b. To be consistent with other examples throughout the regulation, the provision "a" was moved up into 4, making 4 and 4.a one example. Then, "b" was renumbered "5" as its own example. Because "5" is now its own example, the language "Same facts as in Example 4 except" was added to the beginning of the example. This format is also consistent with other examples in this regulation. Secondly, since for purposes of this particular example the term "viewers" is more accurate than "subscribers", "subscribers" was substituted for "viewers".

4. Benefit of the Service – Business Entity, subsection (c)(2)(A). Web Corp provides internet content to its viewers and receives revenue from providing advertising services to other businesses. Web Corp's contracts with other businesses do not indicate the location (or locations) where the benefit of the service is received. The advertisements are shown via the website to Web Corp viewers and the fee collected is determined by reference to the number of times the advertisement is viewed and/or clicked on by viewers of the website. ~~a.~~ If Web Corp, through its books and records kept in the normal course of business, can determine the location from which the advertisement is viewed and/or clicked on by viewers of the website, then gross receipts from the advertising will be assigned to this state by a ratio of the number of viewings and/or clicks of the advertisement in this state to the total number of viewings and/or clicks on the advertisement.

~~b.~~5. Benefit of the Service – Business Entity, subsection (c)(2)(B). Same facts as Example 4~~.~~ except ~~If~~ Web Corp cannot determine the location from which the advertisement is viewed and/or clicked on through its books and records, it shall reasonably approximate the location of the receipt of the benefit by assigning its gross receipts from advertising by a ratio of the number of its viewers in this state to the number of its ~~subscribers~~ viewers everywhere.

23. Subsection (c)(2)(E)6 and 7 are examples with the same facts that show how the third and fourth cascading rules for sales of services to business entities work in the event the first cascading rule (the contract between the taxpayer and the customer or the taxpayer's books and records) and the second cascading rule (reasonable approximation) do not provide a method for determining where the location of the receipt of the benefit of the service, i.e. where the customer has received value from delivery of the service (see definition of "Benefit of a service is received" subsection (b)(1).) Several changes have been made to these examples.

First, what used to be subsection (c)(2)(E)6.a has been brought into what is now subsection (c)(2)(E)6, making the subsections of 6 and 6.a one example. What used to be subsection (c)(2)(E)6.b has been renumbered to 7 and made its own example. Because "7" is now its own example, the phrase "Same facts as Example 6" has been added to the beginning of the example. These changes were made for clarity and consistency with the other examples throughout the regulation.

Second, to make it clearer in this example that the first two cascading rules do not provide a method for determining how much value Western Corp received from Painting Corp's painting services delivered in this state, additional critical factors (shape and surface of the buildings to be painted, and materials used) have been added as necessary facts which are missing so that determination of this state's receipt of its pro-rata portion of value of the painting service under the first two cascading rules is not possible. The "number" factor was deleted because that fact would be known since the location of the buildings is known. "At each location" was deleted as unnecessary. These facts were added or deleted based on comments received for this regulation that assignment could be reasonably approximated.

Third, while it is stated in the example that neither the contract between Painting Corp and Western Corp nor Painting Corp's books and records (the first cascading rule) indicate any method for determination of the extent that the benefit of the services was received in this state, the example failed to specifically mention that there is also no method of reasonable approximation (the second cascading rule) of the extent the benefit of the services was received in this state. It is important that it is clearly stated that the first two cascading rules do not determine assignment of the sale because only then does the next cascading rule apply. As a result, the language "In addition, there is no method for reasonably approximating the location(s) where the benefit of the service was received" has been added to the example. This language allows application of the third cascading rule (the place from which the order was made), which is the purpose of example of (c)(2)(E)6.

If a taxpayer cannot assign the sale to the place from which the order was made (the third cascading rule) then it is assigned to the customer's billing address (the fourth cascading rule) which is the purpose of the example (c)(2)(E)7. The example has been modified to state "subsection (c)(2)(C)" instead of "subparagraph a" to reflect how it is currently numbered.

6. Benefit of the Service – Business Entity, subsection (c)(2)(C). For a flat fee, Painting Corp ~~a~~ contracts with Western Corp to paint Western Corp's various sized, shaped and surfaced buildings located in this state and four (4) other states. The contract does not break down the cost of the painting per building or per state. Painting Corp's books and records kept in the normal course of business indicate the location of the buildings that are to be painted but do not provide any method for determining or reasonably approximating the extent that the benefit of the service is received in this state, i.e. the size, shape, or ~~number~~ surface of each building~~s~~, or the materials used for each building~~s~~ to be painted ~~at each location~~. In addition, there is no method for reasonably approximating the location(s) where the benefit of the service was received. ~~a.~~ Since neither the contract nor Painting Corp's

books and records indicate how much of the fee is attributable to this state and there is no method of reasonably approximating the location of where the benefit of the service is received, the sale will be assigned to this state if the order for the service was placed from this state.

~~b.~~7~~.~~ Benefit of the Service – Business Entity, subsection (c)(2)(D). Same facts as Example 6~~.~~ ~~If~~ except the sale cannot be assigned under ~~subparagraph a.~~ subsection (c)(2)(C), then the sale shall be assigned to this state if Western Corp's billing address is in this state.

24. Subsection (d)(1), the segue for the first cascading rule for sales of intangible property where there has been a complete transfer of all property rights, has been revised to be consistent with the underlying statute, which provides that assignment of sales of intangibles shall be based on the location of the use of the intangible property. As a result, the phrase "location of the use of the" has been inserted before "the intangible property" for purposes of being consistent with the underlying statute. Consequently, the phrase "in this state" has been deleted as unnecessary as it appears in the cascading rules below. This is consistent with other provisions in this regulation.

(1) In the case of the complete transfer of all property rights in intangible property as defined in subsection (b)(~~5~~3), for a jurisdiction or jurisdictions, the location of the use of the intangible property ~~in this state~~ shall be determined as follows:

25. Subsection (d)(1)(A), the first cascading rule for sales of intangible property where there has been a complete transfer of all property rights, has been modified.

First, the phrase "location of the use of the intangible property shall be presumed to be in this state to the extent the" was added to the beginning of the subsection to be consistent with the wording of similar presumptive language in the provisions for assignment of sales of services in subsection (c). Further down in the same sentence, the phrase "shall be presumed to provide where the purchaser will use the intangible at the time of the purchase" was deleted accordingly. Also in the first sentence, the word "indicate" replaces the word "provide" to be consistent with the wording of the provisions for assignment of sales of services in subsection (c). For clarity, the phrase "that the intangible property is used" was inserted before "in this state", and "at the time of sale" was added to the end of the sentence.

In the second sentence, the two words "books and" were added before the word "records" to complete the phrase as it is generally known and so that the term is consistently worded throughout this regulation. Also, "for the most recent twelve (12) month taxable year" was added in order to identify the time period for determining the extent of the use of the intangible property in this state by the taxpayer prior to the sale.

In the third sentence, to be consistent in the wording with other similar provisions in this regulation, the phrase "showing based on" was added prior to the phrase, "preponderance of the evidence" and "showing" was deleted immediately after "preponderance of the evidence."

In the final sentence, for clarity, the term "actual location of the use" was put in place of "purchaser's use" and the phrase "property by the purchaser" was added after the word "intangible" so it now reads "the actual location of the use of the intangible property by the purchaser..." The term "intangible property" was originally referred to here as only "intangible", hence the word "property" was added to "intangible" to complete the term as it is generally known. Commas have been added where appropriate. As a result of rephrasing this sentence, "showing" and "purchaser's use" were deleted.

(A) The location of the use of the intangible property shall be presumed to be in this state to the extent that the contract between the taxpayer and the purchaser, or the taxpayer's books and records kept in the normal course of business~~, shall be presumed to~~ indicate ~~provide where the purchaser will use the intangible at the time of purchase~~ that the intangible property is used ~~it is~~ in this state at the time of the sale. This may include books and records providing the extent that the intangible property is used in this state by the taxpayer for the most recent twelve (12) month taxable year prior to the time of the sale of the intangible property. This presumption may be overcome by the taxpayer or the Franchise Tax Board by showing, based on a preponderance of the evidence, ~~showing~~ that the actual location of the use ~~purchaser's use~~ of the intangible property by the purchaser at the time of purchase is not consistent with the terms of the contract or the taxpayer's books and records.

26. Subsections (d)(1)(A)1, (d)(1)(A)1.a and (d)(1)(A)1.b are assignment rules for sales of intangible property in the event of a sale of an interest in a corporation or a pass-through entity. Subsection (d)(1)(A)1.a was originally set out as an example for the sale of stock (see subsection (d)(1)(D)(1), strikeout version.)

At the hearing for this regulation, comments were received that (1) it is better tax policy to set forth the law in statutory or regulatory provisions instead of by example, (2) sales of interests in pass-through entities should be included, (3) a separate provision should be created for sales of interests where the underlying assets consist of more than 50% intangible property whereby assignment of the sale of the interest should be based on the principles in Revenue and Taxation Code section 25125, subdivision (d), and (4) in calculating the assignment of the sale, the average of the factors referred to in subsection (d)(1)(A)1.a and the sales factor referred to in subsection (d)(1)(A)1.b should be determined by the most recent 12-month taxable year prior to the time of the sale. As a result of these comments, assignment mechanism rules for a sale of stock in a corporation or an ownership interest in a pass-through entity were created in subsections (d)(1)(A)1.a and (d)(1)(A)1.b.

Subsection (d)(1)(A)1 was created as a segue for the rules set forth in (d)(1)(A)1.a and (d)(1)(A)1.b. This is consistent with the provisions in subsection (c).

Subsection (d)(1)(A)1.a reflects the principles of the example originally set out in (d)(1)(D)1 and incorporates the comments received. That subsection states that in the event of a sale of stock in a corporation or an ownership interest in a pass-through entity where 50% or more of the amount of the assets of the corporation or pass-through entity, determined

using the original cost basis, consist of real and/or tangible personal property, the sale will be assigned by averaging the California payroll and property factors of the entity sold. The average of the factors will be determined by the most recent 12-month taxable year prior to the time of sale according to the taxpayer's books and records. It is felt that the payroll and property factors reflect the value and location of where the intangible property, the underlying assets of the entity sold, was employed (see definition of "the use of the intangible property," subsection (b)(6)) at the time of the sale and therefore is an appropriate way to assign the sale of intangible property where 50% or more of the underlying assets consist of real and/or tangible personal property.

Subsection (d)(1)(A)1.b was created to provide for assignment of a sale of stock in a corporation or an ownership interest in a pass-through entity where more than 50% of the amount of the corporation's or pass-through entity's underlying assets, determined by using the original cost basis, consist of intangible property. This subsection states that the sale will be assigned by using the California sales factor of the entity sold for the most recent 12-month tax period prior to the time of sale according to the taxpayer's books and records. This entire subsection is based on comments received at the hearing. Here, the sales factor reflects the value and location of where the intangible property, such as goodwill, was employed (see definition of "the use of intangible property," subsection (b)(6)) at the time of sale, and, as a result, is an appropriate way to determine assignment of sale of stock or ownership interest where the majority of the underlying assets consist of intangible property.

1. Where the sale of intangible property is the sale of stock in a corporation or the sale of an ownership interest in a pass-through entity the following rules apply:

a. In the event that fifty (50) % or more of the amount of the assets of the corporation or pass-through entity sold, determined using the original cost basis of those assets, consist of real and/or tangible personal property, the sale of the stock or ownership interest will be assigned by averaging the payroll and property factors of the corporation or pass-through entity in this state for the most recent twelve (12) month taxable year prior to the time of the sale to the extent indicated by the taxpayer's books and records kept in the normal course of business.

b. In the event that more than fifty (50) % of the amount of the assets of the corporation or pass-through entity sold, determined using the original costs basis of those assets, consist of intangible property, the sale of the stock or ownership interest will be assigned by using the sales factor of the corporation or pass-through entity in this state for the most recent twelve (12) month taxable year prior to the time of the sale to the extent indicated by the taxpayer's books and records.

27. Subsection (d)(1)(B), the second cascading rule of reasonable approximation for sales of intangible property where there has been a complete transfer of all property rights, has been modified to delete the conditions and limitations for reasonable approximation because those conditions and limitations have been moved to the general definition of reasonable approximation at subsection (b)(4), thereby making them applicable to all provisions in this regulation.

(B) If the extent of the use of the intangible property in this state cannot be determined under subparagraph (A) or the presumption under subparagraph (A) is overcome, the location where the intangible property is used shall be reasonably approximated. ~~by reference to the activities of the purchaser, limited to the jurisdictions where the purchaser, at the time of purchase, will use the intangible, to the extent such information is available to the taxpayer. If population is a reasonable approximation, the population used shall be the U.S. population, unless it can be shown by the taxpayer that the intangible is being used materially in other parts of the world. If this is shown then only the populations of those other countries where the intangible is being materially used shall be added to the U.S. population~~.

28. Subsection (d)(1)(C) is the third cascading rule. This rule provides that if the taxpayer cannot apply the rules in (d)(1)(A) or (d)(1)(B), that the location of the customer's billing address will be used to assign sales of intangible property where there has been a complete transfer of all property rights. This rule has been modified to reflect the standard assignment language found in other sections of the Revenue and Taxation Code and Regulations. Typically, assignment will be made "to this state" as opposed to "California" or any location in general. As a result, the words "this state if" were inserted after the phrase "the gross receipts shall be assigned to". Secondly, after the phrase "the billing address of the purchaser" the phrase "is in this state" was added.

(C) If the extent of the use of the intangible property in this state cannot be determined pursuant to subparagraphs (A) or (B), then the gross receipts shall be assigned to <u>this state if</u> the billing address of the purchaser <u>is in this state.</u>

29. Subsection (d)(1)(D)1 is an example showing the application of the cascading rule for assigning a sale of an interest in a corporation or pass-through entity where 50% or more of the amount of the underlying assets, determined by using the original cost basis, are real or tangible personal property. Language was added to indicate that this example addresses the provision where the underlying assets of the corporation or entity sold consist of predominantly tangible personal property. "[A]t the time of sale" was moved to the beginning of the sentence to address both the new language and the first sentence. The phrase, "in its most recent 12-month taxable year preceding the sale", has been inserted to define the time period that the payroll and property factors are to be averaged for determining assignment of the sale of stock.

~~(1)~~ <u>1. Intangible Property – Complete Transfer, Sale of Stock in a Corporation or Ownership Interest in a Pass-through Entity, subsection (d)(1)(A)1.a.</u> Parent Corp sells all of the of stock of Subsidiary Corp. <u>At</u>

the time of sale, the predominant value of Subsidiary Corp's assets consists of tangible personal property and. Subsidiary Corp, at the time of sale, had locations in this state and three (3) other states. Taxpayer's books and records indicate Subsidiary Corp had payroll and property in this state of 15% and 25%, respectively, in its twelve (12) month taxable year preceding the sale. In assigning the receipt from the sale of Subsidiary Corp. Taxpayer may average the property and payroll percentages and assign 20% of the receipt from the sale to this state.

30. Subsection (d)(1)(D)2 has been inserted as an example of the cascading rule in subsection (d)(1)(A)1.b of assigning the sale of stock of a corporation or an interest in a pass-through entity where more than 50% of the amount of the underlying assets, determined by using the original cost basis, is intangible property.

(2) 2. Intangible Property – Complete Transfer, Sale of Stock in a Corporation or Ownership Interest in a Pass-through Entity, subsection (d)(1)(A)1.a. Parent Corp sells an interest in Target Entity. At the time of the sale, the predominant value (over 50%) of Target Entity's assets consists of intangible property. Target Entity's books and records indicate that 30% of Target Entity's sales were assigned to California during the most recent full tax period preceding the sale. Parent Corp may assign 30% of the receipt from the sale of the interest in Target Entity to this state.

31. Subsection (d)(1)(D)3 is an example of the second cascading rule of reasonable approximation for assigning sales of intangible property where a complete transfer of all property rights has been made. This example has been clarified by renaming the corporations by what they do. This is consistent with all other examples in this regulation. As a result, "Taxpayer" has been replaced with "R&D Corp", and "Buyer" has been replaced with "Manu." Also, because this example is intended to show how a taxpayer may reasonably approximate the location of the use of the intangible property, the words "may reasonably approximate the location of the use by assigning" have been inserted in place of the word, "assigns" for clarity.

(3)3. Intangible Property – Complete Transfer, subsection (d)(1)(B). Taxpayer R&D Corp sells a patent to Buyer Manu Corp that will be used by Buyer Manu Corp to manufacture products for sale in the United States. The contract between Taxpayer R&D Corp and Buyer Manu Corp indicates that Buyer Manu Corp will have the exclusive rights to the patent for exploitation in the United States. At the time of the purchase, Taxpayer R&D Corp knows that Buyer Manu Corp has three factories that will use the patented process in manufacturing, one of which is located in this state. In the absence of specific information as to the amount of manufacturing Buyer Manu Corp does at each of the three locations, Taxpayer R&D Corp may reasonably approximate the location of the use by assigning assigns the receipts from the sale equally among the three states where Buyer Manu Corp has manufacturing plants, assigning 33% of the sale to this state.

32. Subsection (d)(1)(D)4 is an example of the third cascading rule. This rule provides that the customer's billing address shall be used for assigning sales of intangible property in the case of a complete transfer of all property rights. This example has been clarified by renaming the corporations by what they do. This is consistent with all other examples in this regulation. As a result, "Taxpayer" has been replaced with "R&D Corp" and "Buyer" has been replaced with "Manu." Also, the word "facts" has been added for clarity. "[S]hall" replaces "may" and "except" replaces "but" to be consistent with other similar provisions in this regulation.

> ~~(1)~~ 4. Intangible Property – Complete Transfer, subsection (d)(1)(C). Same facts as Example ~~(3)~~, ~~but~~ ~~Taxpayer~~ except R&D Corp has no information regarding ~~Buyer~~ Manu Corp's activities. ~~Taxpayer~~ R&D Corp ~~may~~ shall assign the receipt to the billing address of ~~Buyer~~ Manu Corp.

33. Subsection (d)(2)(A)1 is the provision for assignment of sales where the intangible property sold is a "marketing intangible." A commenter for this regulation suggested that the language was duplicative, and, therefore by implication, also unclear. As a result of the comment, changes have been made to clearly articulate the 3 prongs of this marketing intangible provision. The three prongs are: (1) sales are assigned to this state to the extent the ultimate customer of the goods or services to which licensing fees are attributed is in this state, (2) the contract between the taxpayer and licensee or the taxpayer's books and records are presumed to indicate the method for determination of the ultimate customer in this state, and (3) the presumption of the contract or books and records may be overcome based on a preponderance of the evidence.

In connection with the first prong (sales are assigned based on location of ultimate customer), there have been several changes made for clarity. First, the subsection originally contained one long sentence which included the provisions for both the first prong and the second prong. Now, the two prongs have been divided into two separate sentences. The first prong is the first sentence of this subsection and provides the general rule for assignment of sales for marketing intangibles. The second prong is the second sentence and provides the presumptive first cascading rule on how to assign such sales (discussed infra). In the first sentence, the word "ultimate" was added preceding "customer" to make it clear that it is the ultimate customer that determines the location of assignment of the sale. Also, the phrase "presumed to be" was deleted as unnecessary because the first cascading rule (contract or books and records are presumed to indicate the method of location of the ultimate customer) to which the presumption was intended to attach is now in the second sentence.

In connection with the second prong (the contract or books and records are presumed to indicate the method of location of the ultimate customer), the presumption language itself has been rephrased so that it is clearer and consistent with other similar provisions in this regulation. In addition, based on comments received, language clearly stating that the contract or books and records "are presumed" to provide a method for determination of the location of the ultimate customers has been inserted. Also, as in the previous sentence, the word "ultimate" is inserted before "customers" for purposes of clarity. This prong is represented in the second sentence of this subsection.

In connection with the third prong (overcoming the presumption), previously there was no language as to how the presumption could be overcome (thereby allowing application of the second cascading rule of reasonable approximation which appears in the following subsection). Language as to how to overcome the presumption was added as the third sentence to this subsection. It is consistent with other similar provisions in this regulation.

1. Where a license is granted for the right to use intangible property in connection with the sale, lease, license, or other marketing of goods, services, or other items, the royalties or other licensing fees paid by the licensee for such right(s) ~~are presumed to be~~ attributable to this state to the extent that the fees are attributable to the sale or other provision of goods, services, or other items purchased or otherwise acquired by ~~this states~~ ultimate customers in this state.~~, as is provided for by the terms of the contract between the taxpayer and the licensee of the intangible property or the taxpayer's books and records kept in the normal course of business. If~~ The contract between the taxpayer and the licensee of the intangible property or the taxpayer's books and records kept in the normal course of business shall be presumed to provide a method for determination of ~~this state's~~ the ultimate customers in this state for the purchase of goods, services, or other items in connection with the use of the intangible property~~, then the contract's terms or the taxpayer's books and records shall be used to determine this state's customers for the purchase of goods, services, or other items in connection with the use of the intangible property~~. This presumption may be overcome by the taxpayer or the Franchise Tax Board by showing based on a preponderance of the evidence that the ultimate customers in this state are not determinable under the contract or the taxpayer's books and records.

34. Subsections(d)(2)(A)2 provides the second cascading rule for assignment of "marketing intangibles" which states that if assignment cannot be made under the previous provision, then assignment shall be done by reasonable approximation. This subsection was reworded to be consistent with other similar provisions in the regulation, including the addition that if the presumption in the preceding paragraph is overcome, then the location of the use of the intangible property shall be reasonably approximated. This subsection has been modified to delete the conditions and limitations of reasonable approximation because those conditions and limitations have been inserted into the general definition of reasonable approximation in subsection (b)(4), thereby making them applicable to all provisions in this regulation.

Finally, the last sentence provides factors to consider in determining the customer's or licensee's use of "marketing intangibles." This provision was originally located under "Special Rules" in subsection (g)(2) and applicable to the regulation as a whole. However, the rule is specific to assignment of sales of "marketing intangibles" and therefore was relocated to the provision for the first cascading rule for assignment of "marketing intangibles." The phrase "including population" was deleted as unnecessary. For clarity, other changes were made and include replacing "intangible property" with "marketing intangibles" and deleting "for use of marketing intangibles".

2. If the location of the use of the intangible property is not determinable under subparagraph 1 or the presumption under subparagraph 1 is overcome, the location of the use of the intangible property shall be reasonably approximated. ~~by reference to the activities of the taxpayer's licensee customer to the extent such information is available to the taxpayer. Reasonable approximation of the location of the use of the intangible property includes, but is not limited to, the percentage of this state's population as compared with the total population of the geographic area in which the licensee uses the intangible property to market its goods, services or other items, to the extent such information is available to the taxpayer.~~ To determine the customer's or licensee's use of ~~intangible property~~ marketing intangibles in this state ~~under subsection (d)(2)(A)2 for use of marketing intangibles~~, factors that may be considered include the number of licensed sites in each state, the volume of property manufactured, produced or sold pursuant to the arrangement at locations in this state, or other data ~~including population~~ that reflects the relative usage of the intangible property in this state.

35. Subsection (d)(2)(A)3 is a population assignment provision specific for marketing intangibles sold at the wholesale level. The assignment language was modified to be consistent with the language for the use of population as a method of assignment in the definition of reasonable approximation in subsection (b)(4).

3. Where the license of a marketing intangible property is for the right to use the intangible property in connection with sales or other transfers at wholesale rather than directly to retail customers, the taxpayer may be unable to develop information regarding the location of the ultimate use of the intangible property. If this is the case, then the taxpayer may attribute the receipt to this state based solely upon the percentage of this state's population as compared with the total population of the geographic area in which the licensee uses the intangible property to market its goods, services or other items. ~~Only the populations of those countries where the intangible is being materially used shall be taken into account.~~ The population used shall be the U.S. population, unless it can be shown by the taxpayer that the intangible property is being used materially in other parts of the world. If this is shown then only the populations of those other countries where the intangible is being materially used shall be added to the U.S. population.

36. Subsection (d)(2)(B)1 is the first cascading rule regarding non-marketing or manufacturing intangibles. For consistency purposes, the provision was changed to mirror the first cascading rule of marketing intangibles in subsection (d)(2)(A)1. Thus, the first sentence provides the general rule for assignment of non-marketing/manufacturing sales, and the second sentence contains the presumptive first cascading rule on how to assign such sales. The third sentence is now consistent with marketing intangibles and other similar provisions in the regulation and provides language on overcoming a presumption. Thus, "by a preponderance of the evidence" was deleted and "by showing, based on a preponderance of the evidence, that the extent of the use for which the fees are paid are

not determinable under the contract between the taxpayer and the licensee of the intangible property or the taxpayer's books and records" was inserted in its place.

(B) Non-marketing and manufacturing intangibles.

1. Where a license is granted for the right to use intangible property other than in connection with the sale, lease, license, or other marketing of goods, services, or other items, the licensing fees paid by the licensee for such right(s) are ~~presumed to be~~ attributable to this state to the extent that the use for which the fees are paid takes place in this state~~, as is provided for by~~. ~~t~~The terms of the contract between the taxpayer and the licensee of the intangible property or the taxpayer's books and records kept in the normal course of business shall be presumed to~~. If the contract or the taxpayer's books and records~~ provide a method for determination of the extent of the use of the intangible property in this state~~, then the contract's terms or the taxpayer's books and records will be presumed to properly indicate the extent of the use of the intangible property in this state~~. This presumption may be overcome ~~by~~ ~~a preponderance of the evidence~~ by the taxpayer or the Franchise Tax Board by showing, based on preponderance of evidence, that the extent of the use for which the fees are paid are not determinable under the contract or the taxpayer's books and records.

37. Subsection (d)(2)(B)2 provides the second cascading rule for the assignment of sales of non-marketing and manufacturing intangibles. The phrase "for which the fees are paid" was deleted as unnecessary and inconsistent with the language of similar provisions in the regulation. Finally, this subsection has been modified to delete the conditions and limitations of reasonable approximation because those conditions and limitations have been moved to the general definition of reasonable approximations at subsection (b)(4), making them applicable to all provisions of this regulation.

2. If the location of the use of the intangible property ~~for which the fees are paid~~ cannot be determined under subparagraph 1 or the presumption in subparagraph 1 is overcome, then the location of the use of the intangible property shall be reasonably approximated. ~~by reference to the activities of the taxpayer's customer, to the extent such information is available to the taxpayer.~~

38. Subsection (d)(2)(C)1 is the first cascading rule for assignment of sales of mixed intangibles. For clarity, the single word "Where" was replaced with the phrase "Where a license of intangible property includes both a license of a marketing intangible and a license of a non-marketing or manufacturing intangible and..." in the last sentence "or manufacturing" was added to "non-marketing" to complete the term, mixed intangibles, as it is defined in subsection (b)(3)(C).

(C) Mixed intangibles.

1. Where a license of intangible property includes both a license of a marketing intangible and a license of a non-marketing or manufacturing intangible and the fees to be paid in each instance are separately stated in the licensing contract, the Franchise Tax Board will accept such separate statement for purposes of this section if it is reasonable. If the Franchise Tax Board determines that the separate statement is not reasonable, then the Franchise Tax Board may assign the fees using a reasonable method that accurately reflects the licensing of a marketing intangible and the licensing of a non-marketing or manufacturing intangible.

39. Subsection (d)(2)(C)2 is the second cascading rule for assignment of sales of mixed intangibles. The phrase "a license of intangible property includes both a license of a marketing intangible and a license of a non-marketing intangible" is unnecessary as the definitional language of a mixed intangible already appears immediately above in subsection (d)(2)(C)1. Since this second rule immediately follows the first rule, it is unnecessary to define the term again. Finally, the language on how to overcome the presumption has been added to the end of this provision. This is consistent with other similar subsections of this regulation.

2. Where ~~a license of intangible property includes both a license of a marketing intangible and a license of a non-marketing intangible and~~ the fees to be paid in each instance are not separately stated in the contract, it shall be presumed that the licensing fees are paid entirely for the license of a marketing intangible except to the extent that the taxpayer or the Franchise Tax Board can reasonably establish otherwise. This presumption may be overcome, by a preponderance of the evidence, by the taxpayer or the Franchise Tax Board, that the licensing fees are paid for both the licensing of a marketing intangible and the licensing of a non-marketing or manufacturing intangible, and the extent to which the fees represent the marketing intangible and the non-marketing or manufacturing intangible.

40. Subsection (d)(2)(D)2 is an example for reasonable approximation for assigning sales of marketing intangibles." "Sports" replaces "Whole" to give the corporation in the example a clearer identity so that the example is easier to understand. In addition, to make it clear that the taxpayer could not determine assignment based on the first cascading rule (the contract or the taxpayer's books and records), language is inserted to state that fact: "Neither the contract between the taxpayer and the licensee nor the taxpayer's books and records provide a method for determination of this state's customers of equipment manufactured with Moniker Corp's trademarks." Finally, to make it clear that this is a reasonable approximation example, the word "determined" is replaced with the term "reasonably approximated."

2. Intangible Property – Marketing Intangible, subsection (d)(2)(A)1. ~~Marketing intangible~~. Moniker Corp enters into a license agreement with ~~Whole~~ Sports Corp where ~~Whole~~ Sports Corp is granted the right to use trademarks owned by Moniker Corp to brand sports equipment

that is to be manufactured by ~~Whole~~ Sports Corp or an unrelated entity, and to sell the manufactured product to unrelated companies that make retail sales in a specified geographic region. Although the trademarks in question will be affixed to the tangible property to be manufactured, the license agreement confers a license of a marketing intangible. Neither the contract between the taxpayer and the licensee nor the taxpayer's books and records provide a method for determination of this state's customers of equipment manufactured with Moniker Corp's trademarks. The component of the licensing fee that constitutes sales of Moniker Corp in this state is ~~determined~~ reasonably approximated by multiplying the amount of the fee by the percentage of this state's population over the total population in the specified geographic region in which the retail sales are made.

41. Subsection (d)(2)(D)3 is an example for the assignment of sales of a marketing intangible where the sale is to a wholesaler. The previous draft did not contain a wholesale example. As stated above, it is the intent to provide an example to show how each rule in this regulation works.

3. Intangible Property - Marketing Intangible, Wholesale, subsection (d)(2)(A)3. Cartoon Corp enters into a license agreement with Wholesale Corp where Wholesale Corp is granted the right to use Cartoon Corp's cartoon characters in the design and manufacture of tee shirts and sweatshirts which will be sold to various retailers who will in turn sell them to members of the public. Cartoon Corp is unable to develop information regarding the location of the ultimate customer of the products designed and manufactured in connection with Cartoon Corp's cartoon characters. Cartoon Corp shall assign the licensing fee by multiplying the fee by the percentage of this state's population over the total population in the geographic area in which Cartoon Corp markets its goods, services or other items.

42. Subsection (d)(2)(D)5 is an example of the second cascading rule of reasonable approximation for assignment of a sale of a non-marketing or manufacturing intangible property. The previous draft did not contain an example for reasonable approximation in connection with assignment of the sale of non-marketing or manufacturing intangibles, and as stated above, it is the intent to provide an example to show how each rule in this regulation works.

5. Intangible Property - Non-marketing or Manufacturing Intangible, subsection (d)(2)(B)2. Mechanical Corp enters into a license agreement with Spa Corp where Spa Corp is granted the right to use the patents owned by Mechanical Corp to manufacture mechanically operated spa covers for spas that Spa Corp manufactures. Neither the terms of the contract nor the taxpayer's books and records indicate the extent of the use of the patent in this state. However, there is public information that Spa Corp has 3 manufacturing locations in this state and an additional 6 manufacturing locations in various other states.

Mechanical Corp may reasonably approximate the location of the use of the intangible property and assign 33% of the licensing fees to this state.

43. Subsection (d)(2)(D)6 is an example of the third cascading rule of the customer's billing address for assignment of a sale of a non-marketing or manufacturing intangible. The previous draft did not contain an example for customer's billing address, and as stated above, it is the intent to provide an example to show how each rule in this regulation works.

6. Intangible Property - Non-marketing and Manufacturing Intangible, subsection (d)(2)(B)3. Same facts as Example 5 except that Spa Corp is a small, privately held manufacturing corporation that has no publicly available information as to its manufacturing locations, Mechanical Corp shall assign all of the licensing fees to this state if Spa Corp's billing address is in this state.

44. Subsections (d)(2)(D)7 and 8 provide examples of how the two cascading rules for mixed intangibles work. Inadvertently, the facts of the two examples originally appeared in reverse order for application of the cascading rules. The examples' facts have been modified so that they appear in the same order as the cascading rules for mixed intangibles. Thus subsection (d)(2)(D)7's facts refer to where there is a separate and reasonable statement of fees and how the sale would be assigned under those facts, and subsection (d)(2)(D)8's facts refer to where there is no separate statement of fees and how the sale would be assignment under those facts.

~~4~~7. Intangible Property – Mixed Intangible, subsection (d)(2)(C)1. ~~Mixed intangible~~. Axel Corp enters into a two-year license agreement with Biker Corp in which Biker Corp is granted the right to produce motor scooters using patented technology owned by Axel Corp, and also to sell such scooters by marketing the fact that the scooters were manufactured using the special technology. The scooters are manufactured outside this state, but the taxpayer is granted the right to sell the scooters in a geographic area in which this state's population constitutes 25% of the total population in the geographic area during the period in question. The license agreement specifies separate fees to be paid for the right to produce the motor scooters and for the right to sell the scooters by marketing the fact that the scooters were manufactured using the special technology. The licensing agreement constitutes both the license of a marketing intangible and the license of a non-marketing intangible. Assuming that the separately stated fees are reasonable, the Franchise Tax Board will: (1) attribute no part of the licensing fee paid for the non-marketing intangible to this state, and (2) attribute 25% of the licensing fee paid for the marketing intangible, to this state. ~~The licensing agreement requires an upfront licensing fee to be paid by Biker Corp to Axel Corp but does not specify which percentage of the fee is derived from Biker Corp's right to use Axel Corp's patented technology. Unless either the taxpayer or the Franchise Tax Board~~

~~reasonably establishes otherwise, it is presumed that the licensing fees are paid entirely for the license of a marketing intangible. In such cases, it will be presumed that 25% of the licensing fee constitutes sales in this state.~~

~~5~~8. Intangible Property – Mixed Intangible, subsection (d)(2)(C)2. ~~Mixed intangible.~~ Same facts as Example ~~4~~7, except that ~~the license agreement specifies separate fees to be paid for the right to produce the motor scooters and for the right to sell the scooters by marketing the fact that the scooters were manufactured using the special technology. The licensing agreement constitutes both the license of a marketing intangible and the license of a non marketing intangible. Assuming that the separately stated fees are reasonable, the Franchise Tax Board will: (1) attribute no part of the licensing fee paid for the non marketing intangible to this state, and (2) attribute 25% of the licensing fee paid for the marketing intangible to this state. T~~the licensing agreement requires an upfront licensing fee to be paid by Biker Corp to Axel Corp but does not specify which percentage of the fee is derived from Biker Corp's right to use Axel Corp's patented technology. Unless either the taxpayer or the Franchise Tax Board reasonably establishes otherwise, it is presumed that the licensing fees are paid entirely for the license of a marketing intangible. In such cases, it will be presumed that 25% of the licensing fee constitutes sales in this state.

45. Subsection (g)(1) provides that the Franchise Tax Board shall consider the effort and expense required to obtain the necessary information to comply with these regulations. The reference is to "assigning sales to the sales factor numerator pursuant to Revenue and Taxation Code section 25136." It should reference Revenue and Taxation Code section 25136, subdivision (b), which is the underlying statutory provision for the market-based rules of assigning sales other than sales of tangible personal property. This change has been made.

(1) In assigning sales to the sales factor numerator pursuant to Revenue and Taxation Code section 25136(b), the Franchise Tax Board shall consider the effort and expense required to obtain the necessary information, as well as the resources of the taxpayer seeking to obtain this information, and may accept a reasonable approximation when appropriate, such as when the necessary data of a smaller business cannot be reasonably developed from financial records maintained in the regular course of business.

46. Subsection (g)(1)(A) is an example under "Special Rules" to indicate facts when a taxpayer would not be required to alter its recordkeeping method to comply with the provisions of this regulation. A comment at the hearing for this regulation was made that the example gave the impression that only a small corporation would be able to qualify within this provision. As a result, the name of the corporation in the example has been changed to "Misc".

(A) Example. ~~Small~~ Misc Corp, a corporation located in this state, provides limited bookkeeping services to clients both within and outside this state. Some clients have several operations among various states. For the past ten (10) years, ~~Small~~ Misc Corp's only records for the sales of these services have consisted of invoices with the billing address for the client. ~~Small~~ Misc Corp's records have been consistently maintained in this manner. If the FTB determines that ~~Small~~ Misc Corp cannot determine, pursuant to financial records maintained in the regular course of its business, the location where the benefit of the services it performs are received under the rules in this regulation, then ~~Small~~ Misc Corp's sales of services will be assigned to this state using the billing address information maintained by the taxpayer. ~~Small~~ Misc Corp will not be required to alter its recordkeeping method for purposes of this regulation.

47. Subsection (g)(2) lists factors for determination of the location of the use of marketing intangibles. This was moved to the provisions regarding marketing intangibles as subsection (d)(2)(A)2.a. It was determined that this was not a general rule that applied to the entire regulation.

(~~2~~) ~~To determine the customer's or licensee's use of intangible property in this state under subsection (d)(2)(A)2. for use of marketing intangibles, factors that may be considered include the number of licensed sites in each state, the volume of property manufactured, produced or sold pursuant to the arrangement at locations in this state, or other data including population that reflects the relative usage of the intangible property in this state.~~

48. Subsection (g)(2) is now segue to special rules for reasonable approximation of the location for receipt of the benefit of the services or the location of the use of the intangible property. "[T]he receipt of" was inserted to match the language of the underlying statute and other provisions of this regulation.

(~~3~~2) The following special rules shall apply in determining the method of reasonable approximation of the location for the receipt of the benefit of the services or the location of the use of the intangible property:

49. Subsection (g)(2)(A) provides that once a reasonable approximation method is used, the taxpayer must continue to use that method unless the Franchise Tax Board gives permission for a change to the method. To match the language of the underlying statute and remain consistent with other provisions of this regulation, "receipt of the" was inserted before "benefit of the services." In addition, it has been determined that in fairness to taxpayers, once the Franchise Tax Board has examined the taxpayer's reasonable approximation method and accepted it, the Franchise Tax Board will continue to accept that method until facts and circumstances change such that the method no longer reasonably reflects the market. This is consistent with other provisions of the Revenue and Taxation Code and other Regulations. As a result, language to that effect has been added to this provision.

(A) Once a taxpayer has used a reasonable approximation method to determine the location of the market for the receipt of the benefit of the services or the

location of the use of the intangible property, then the taxpayer must continue to use that method in subsequent taxable years. A change to a different method of reasonable approximation may not be made without the permission of the Franchise Tax Board. Where the Franchise Tax Board has examined the reasonable approximation method and accepted it in writing, the Franchise Tax Board will continue to accept that method, absent any change of material fact such that the method no longer reasonably reflects the market for the receipt of the benefit of the services or the location of the use of the intangible property.

50. Subsection (g)(3)(A) refers to Revenue and Taxation Code section 25136 and Regulation section 25136. "RTC" is changed to "Revenue and Taxation Code". "CCR" is changed to "Regulation" to be consistent with other provisions of this regulation and other regulations. Also, to reflect that the reference is to the market-based rules, it now reads, where appropriate, "Revenue and Taxation Code section 25136, subdivision (a), and Regulation section 25136-2."

(A) All references to ~~RTC~~ Revenue and Taxation Code section and ~~CCR~~ Regulation section 25136 shall refer to ~~RTC~~ Revenue and Taxation Code section 25136(b) and ~~CCR~~ Regulation section 25136-2 as they are operative beginning on and after January 1, 2011.

51. Subsection (g)(3)(C) refers to the incorporation of special industry rules for Franchisors. A comment on this regulation was received that, based on the wording of the subsection, there might be confusion as to whether or not throwout rules apply. To avoid any confusion that throwback or throwout rules apply, language has been inserted indicating that the taxability of a taxpayer in a state is not relevant under the market-based rules. Neither throwback nor throwout rules apply under these market-based rules.

(C) The provisions in Regulation section 25137-3 [Franchisors] that relate to the taxpayer being, or not being, taxable in a state shall not be applicable.

52. Subsection (g)(3)(F) relates to the incorporation of special industry rules for mutual fund providers and specifically refers to assignment of receipts to the location of income-producing activity in the event the taxpayer is not taxable in a state. Those provisions are not applicable to the market-based rules of this regulation and the underlying statute. There is no statutory authority for assignment of a receipt to the location of the income-producing activity if it is not the market state. Therefore, the taxability of a taxpayer in a state which triggers the assignment to the location of the income-producing activity is immaterial and should be eliminated to avoid confusion. At the hearing for this regulation, there was a comment made on that basis.

(F) The provisions in Regulation section 25137-14 that relate to the taxpayer not being taxable in a state and assign the receipts to the location of the income-producing activity that gave rise to the receipts shall not be applicable.

These sufficiently related changes are being made available to the public for the 15 day period required by Government Code section 11346.8, subdivision (c), and California Code of Regulations, title 1, section 44. Written comments regarding these changes will be accepted until 5:00 p.m. on October 24, 2011. The Franchise Tax Board is sending a copy of the proposed amendments to Regulation section 25136 to all individuals who requested notification of such changes, as well as those who commented in writing to the previously noticed proposed amendments to Regulation section 25136.

All inquiries and written comments concerning this notice should be directed to Colleen Berwick at 916-845-3306, FAX 916-845-3648, E-Mail colleen.berwick@ftb.ca.gov; or by mail to the Legal Division, Attn: Colleen Berwick, P.O. Box 1720, Rancho Cordova, CA 95741-1720. The notice and the proposed amendments will also be made available at the Franchise Tax Board's website at http://www.ftb.ca.gov/.